

Central Intelligence Agency



Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

23 JAN 1984

MEMORANDUM FOR: E. Allan Wendt
Deputy Assistant Secretary for
International Energy Policy
Department of State

FROM: [REDACTED]
Director of Global Issues

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SUBJECT: Risks of an Oil Price Decline [REDACTED]

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I would like to raise to your attention the attached report prepared by members of my staff concerning the issue of oil price stability over the next several months. In our view the risk of an oil price decline will increase during the months ahead as seasonal demand for oil slackens and some financially troubled countries, like Nigeria, attempt to increase their market share. While we would not specifically forecast a sharp price decline or unravelling in the market, it remains a possibility that you should be aware of. If you or members of your staff have questions concerning the report, please call.

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Attachment:

Risks of an Oil Price Decline
GI M 84-10010, January 1984

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SUBJECT: Risks of an Oil Price Decline

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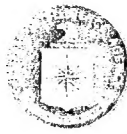
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DIRECTORATE OF INTELLIGENCE

20 January 1984

Risks of an Oil Price DeclineSummary

Overproduction, low demand and weak spot prices have kept downward pressure on oil prices and recently forced a number of producers to lower prices. Eroding discipline among OPEC countries and prospects of a seasonal cutback in oil demand this spring could place additional strong pressures on the current price structure. Nigeria, OPEC's weakest link and possessor of a new government, in particular continues to suffer economic problems that might prompt Lagos to announce a unilateral price cut. If Nigeria and others move to increase their market share to help address financial problems, a downward oil price spiral could ensue. The central factor working against such an eventuality would once again be Saudi willingness to cut their production. At this point, Saudi Arabia appears willing to defend the current benchmark price but only as long as other producers adhere closely to their production quotas. The political situation in the Middle East remains unsettled and market conditions could tighten if Iran or Iraq disrupt oil flows from the region. [redacted]

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This memorandum was prepared by [redacted]
[redacted] Energy Issues Branch,
Office of Global Issues. The information contained herein is
updated to 20 January 1984. Comments may be directed to [redacted]
[redacted] Chief, Strategic Resources Division, [redacted]

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Risks of an Oil Price DeclineCurrent Situation

Overproduction and weak consumption have put downward pressure on prices in recent months. OPEC crude production in the fourth quarter averaged about 19 million b/d, some 1.5 million b/d above the cartel's production ceiling. We estimate non-Communist oil consumption in the fourth quarter rose by about 1 percent, considerably less than most companies had anticipated. Consequently, oil inventories at yearend remained in excess of company needs and spot prices for most crudes have declined to about \$1 below official prices. [redacted]

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The potential for a replay of last year's oil price drop is mounting even though underlying market conditions are working in favor of price maintenance.

- o Unlike the sharp 6 percent decline in fourth quarter oil use in 1982, oil consumption actually increased in the same period in 1983.
- o Weather conditions in North America are decidedly colder than last year, boosting consumption of fuel oil and other heating fuels.
- o The level of excess inventories is less than that of a year ago. Oil stocks at yearend stood at 90 days of consumption compared to 96 days at yearend 1982.
- o OPEC crude production of 18.7 million b/d in December was about 500,000 b/d below year earlier levels.
- o Spot oil prices have weakened but the decline is not as sharp as last year. Spot prices for most crudes are now about \$1 below official prices compared to a \$3 to \$4 spread early last year. [redacted]

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Price Developments

Nonetheless, in addition to weak spot prices and growing financial pressures in several oil producing countries, several other signals indicate a repeat of last year's oil price slide may be developing.

- o The Soviet Union reduced its price by \$1 per barrel late last year and Egypt lowered its contract prices by \$.25 to \$.50 per barrel effective 1 January. In addition, Cairo announced it would review oil prices monthly. Both countries are now undercutting comparable OPEC crudes by about \$1 per barrel.

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- o Statoil, the Norwegian oil company, reduced the price of its Statfjord crude by \$.20 per barrel in early January.
- o The British National Oil Corporation (BNOC) proposed freezing contract prices for first quarter 1984 at current levels, but still faces some buyer resistance to its proposal.
- o In late November, Qatar reportedly offered a 100,000 b/d one-year contract to a US firm at a discount of \$.90 per barrel off the official price.
- o [redacted] Indonesia's Pertamina is marketing crude oil under arrangements that effectively discount its oil by \$1 to \$2 per barrel in an effort to boost crude export volumes. 25X1
- o Ecuador lowered its crude oil price by \$.70 per barrel in January.
- o Iran recently signed crude contracts for as much as 1 million b/d with several major customers at prices pegged to spot prices, [redacted] 25X1
- o [redacted] Tehran also reportedly eased distribution restrictions and will allow customers to swap crude to third parties. 25X1
- o Oman effectively lowered the selling price of its crude 45 cents per barrel to Japanese and British buyers by extending the payment period, according to press reports.
- o Libya is offering at least one producing company a rebate of \$1 per barrel on oil produced in January. 25X1

[redacted]
[redacted]

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Near Term Demand Outlook

The near term demand outlook will depend mainly on the pace of the economic recovery in OECD countries, inventory patterns and seasonal weather conditions. Based on available information, we expect a modest increase in oil consumption in early 1984 in response to the continued economic recovery, further erosion in real oil prices and projected weather patterns. As a result, we expect non-Communist consumption to record about a 2 percent increase in first half 1984 over year earlier levels. We estimate first-quarter consumption at about 46 million b/d with an expected seasonal decline in consumption to 43 million b/d in the second-quarter. Our consumption forecast is in agreement with most recent industry projections. [redacted]

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If consumption predictions hold, inventory decisions will play the key role in determining the level of oil demand at least through first-half 1984. Oil companies still have leeway to reduce inventories because of overproduction and unexpectedly weak consumption in the fourth-quarter. Prospects of continued price weakness will also likely cause stockholders to run down excess inventories in early 1984. We have assumed in our base case that most excess inventories--estimated at about 200 million barrels--are drawn down during first-half 1984. As a result, we anticipate that the inventory drawdown through March will approximate 2.5 million b/d, followed by little or no seasonal stockbuild during the second-quarter. [redacted]

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Under our base case conditions, demand for OPEC oil, including 1 million b/d of natural gas liquids, will approximate 18.5 million b/d in first-half 1984, or some 1.5 million b/d below fourth quarter levels. Should the rebound in total oil consumption fail to materialize, demand for OPEC oil in first half 1984 could fall one million b/d or more below the group's current production ceiling. Unless OPEC producers cut production accordingly, oil prices will fall. [redacted]

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Price Pressures in the Months Ahead

The key to the near term price outlook under these circumstances will be producer cooperation. While OPEC reaffirmed its nine-month old production accord in early December, this action did little to improve compliance and the cartel is not scheduled to formally consider changes until July 1984. Given the growing financial pressures in several producing countries and the political animosity between some members, OPEC could be hard pressed to maintain an effective production sharing agreement in the months ahead. Competition between the United Kingdom and Nigeria for market share over the next few months could trigger price cuts by either country and set off a downward price spiral. [redacted]

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United Kingdom

In the absence of more discipline from OPEC countries, official oil prices of some non-OPEC producers--especially the United Kingdom--could again come under pressure. Because London has no mechanism to shut in oil production, prices are generally set in line with market conditions. We expect London to attempt to hold prices through the first quarter, but a reduction in US domestic oil prices or a further weakening in spot prices that causes a major buyer exodus could force a British price reduction. Rapid acceptance of BNOC's price proposal by the major oil companies operating in the UK indicates that these companies at least have little desire to see prices fall. Indeed, recent press reports indicate that these companies may voluntarily limit oil output in coming months to reduce price pressures. The companies are aware that a British cut could trigger price cuts by other producers, especially Nigeria, since

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Lagos produces oil that competes directly with North Sea crudes: If some price reduction does become necessary, BNOC probably first will attempt to adjust prices of crudes other than Brent--now priced the same as Nigeria's Bonny Light--in an attempt to technically leave British and Nigerian prices at parity. Any unilateral reduction in oil prices by the Nigerians, however, probably would be quickly matched by the United Kingdom. [redacted]

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Nigeria

Pressing revenue needs in the face of weak demand for Nigerian crudes could force the new Buhari regime to lower prices in an attempt to boost oil sales. [redacted]

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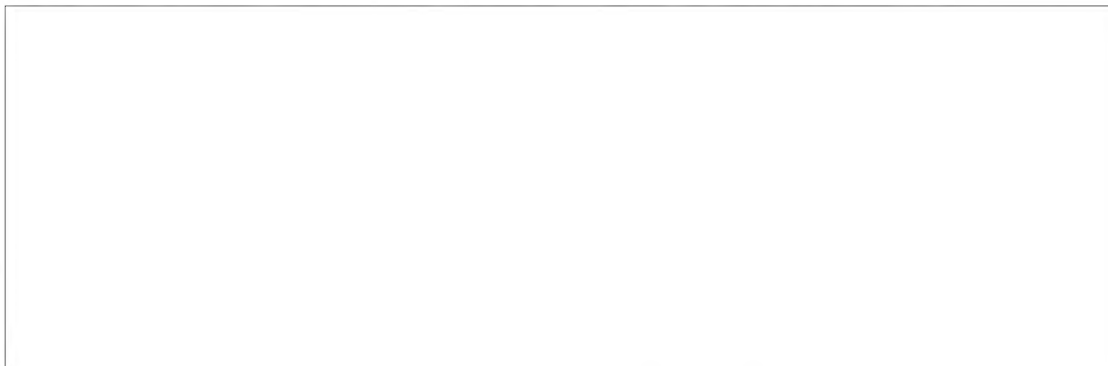
Most equity producers in Nigeria view Buhari as experienced in oil matters, having served as chairman of the NNPC in the 1970s. We believe this experience will sensitize Buhari to the advantages of moving slowly on any pricing decision because he is fully aware of the impact of a price war on Nigeria's economy. Indeed, General Buhari has stated publicly his intention to remain in OPEC and that any change in its OPEC membership would come only after consultation with other cartel members. Given Buhari's oil experience, he may eventually use the threat of a price cut and production increase to seek financial assistance from other OPEC members. [redacted]

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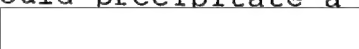
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Other OPEC Members

Several other OPEC countries faced with financial problems are under pressure to increase export earnings. We would expect that most of these producers would match any sizable Nigerian price cut.

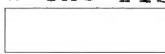


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- o Iran probably will continue tying crude oil export prices to the prevailing spot market price. Iran's new pricing arrangement could encourage other OPEC members who produce comparable quality crudes to negotiate similar deals rather than risk losing market shares.
- o Libya was unable to sell much of its December production, and Libyan oil officials reportedly fear continued weak demand could precipitate a further reduction in liftings. 

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Saudi Arabia -- the Key Player

Saudi Arabia will play the key role in determining oil price developments from the producer side, in our view. Although the Saudis may believe OPEC oil is still overpriced, Riyadh is mindful of the dangers of an uncontrolled round of price cuts and the damage it could do to itself. Unlike last year, the Saudis have not issued public threats to reduce the price of oil and have, in fact, stated their support for the current price. As a result, we feel the Saudis currently view defense of OPEC's \$29 per barrel marker price as the best option available. Indeed, Saudi production has fallen gradually from its September 1983 peak of 6.2 million b/d to 5.6 million b/d in December and we expect January's output will approximate 5.2 million b/d. If demand weakens during first half 1984 as we now expect, Riyadh probably will be willing to cut output below 5 million b/d--perhaps as low as 4 million b/d--to defend prices. If, however, other OPEC countries do not adhere closely to their production ceilings and force Saudi output even lower, Riyadh may reconsider its options and the risk of a price collapse would be considerable. 

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The Iran-Iraq Risk

Although we expect the market to remain weak over the coming months, the volatile situation in the Middle East could cause a rapid turnabout in the market. Iraq's deteriorating economic situation, coupled with the recent acquisition of French Super Etendard aircraft with Exocet missiles, could prompt Baghdad to initiate attacks against oil shipping in the Persian Gulf in an effort to bring an end to the conflict with Iran. Such action might induce Iran to carry out its oft repeated threat to retaliate by closing the Gulf to shipping or to strike out against the oil facilities of Iraq and its Persian Gulf allies. Any major disruption to oil flows in the region could quickly tighten supplies and reverse market psychology. [REDACTED]

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Oil Price Indicators

Key factors to observe over the coming weeks that might portend a decline in oil price are:

- o Levels of OPEC production well in excess of the cartel's 17.5 million b/d quota with Saudi output in excess of 5.5 million b/d being a key factor.
- o Absence of a sustained rebound in oil consumption.
- o Falling spot crude prices that dip \$2-4 below official prices.
- o Exodus of buyers for North Sea crudes, forcing BNOC to step up spot market sales.
- o A sharp decline in Nigerian production to well below 1 million b/d.
- o Saudi hints that it is no longer willing to defend the benchmark.
- o Increases in price discounts such as barter deals, credit terms or linkages with spot price deals in countries such as Libya, Iran, and Nigeria.

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